
WHEN THERE IS MORE THAN ONE OPTION

Structuring the ownership and beneficiary designation for a business-related life insurance policy can be very complex. Properly structured, the creditor protection of the insurance policy can be enhanced and the business owner may be able to realize tax savings in the estate or fund the policy with lower-cost dollars. If the plan is improperly structured, however, the tax savings will not materialize, the policy could be lost to creditors and the business owner's plans will not be achieved.

Typically the ownership of the policy is either personal or corporate. As with any planning strategy, there are a number of pros and cons with respect to corporate-owned life insurance.

Cost: One advantage of corporate-owned life insurance can be its cost. It can cost less to fund the policy with corporate dollars than with personal dollars. The payment of the insurance premium is generally not a tax-deductible expense. It is therefore less expensive to have the insurance premium paid by the party in the lowest tax bracket – often, this is the corporation.

Creditor protection: The chief disadvantage of corporate ownership is that the policy loses its creditor-sheltering ability. In general terms, a life insurance policy is only exempt from seizure by creditors to the extent that the owner has named a beneficiary. If the policy is corporate-owned and death proceeds are payable to the corporation, there is no designated beneficiary. (Note that under

provincial insurance legislation, the definition of “beneficiary” excludes the owner of the policy.) Therefore, the policy is exposed to the creditors of the company. The policy may also be exposed to the creditors of the shareholders, to the extent those creditors can force the shareholders to extract funds from the company.

The capital dividend account: Corporate ownership of a life insurance policy can generate a credit to the company's capital dividend account. In general terms, amounts can be paid out of this account to shareholders as tax-free dividends. Whether the corporate-owned life insurance is used to fund a buy-sell arrangement or fund the deceased's income tax liability, a credit to the capital dividend account can be used as part of a tax planning strategy to lower the income tax liability of the deceased, allowing more capital to be retained by the surviving family.

Only a portion of the death benefit of the life insurance can be removed from the company on a tax-free basis, however, since the credit to the company's capital dividend account is the excess of the death benefit received over the company's adjusted cost basis in the policy. This means that the amount representing the company's adjusted cost basis cannot be removed from the company tax-free. With personally owned life insurance, the beneficiary would receive the entire insurance proceeds tax-free.

Also note that the tax-free dividend will be paid to all shareholders of that class

of shares. If only one or a few of those shareholders are the intended recipient(s), careful estate planning is needed to ensure that the appropriate distribution occurs.

Another disadvantage can arise with respect to the capital dividend account when several lives are insured under the same policy. In this circumstance, the credit to the capital dividend account is the life insurance proceeds received in excess of the company's adjusted cost basis. Upon the first death, the company's adjusted cost basis for the entire policy would be used in the calculation. However, the adjusted cost basis is not reduced upon the death of a life insured. Upon the death of a second life insured, the adjusted cost basis, together with further adjustments during the intervening period, would again be used to reduce the amount that is credited to the company's capital dividend account. The overall effect is that the same costs may reduce the credit to the capital dividend account multiple times.

Transferring ownership: Care should be taken in situations involving buy-sell arrangements to ensure that the shareholders whose lives are insured have a right to acquire the corporate-owned life insurance policies when the corporation no longer needs the coverage. The terms of such a right would be recorded in the shareholders' agreement. Without such a right, a departing shareholder would have to negotiate with the remaining shareholders at a time when agreement may not be possible. Transfers of ownership may also be required if the business owner decides to sell the shares of the business that owns insurance policies on his or her life.

If a life insurance policy is transferred from corporate ownership to personal ownership, then care will have to be taken with respect to the value assigned to the policy upon transfer. The Income Tax Act deems the policy to be transferred by the corporation at its cash surrender value in this situation. However, the Income Tax Act may also assess a taxable

shareholder benefit equal to the fair market value of the policy less any consideration paid. The fair market value of a life insurance policy takes into consideration the health of the life insured, the cost of replacement coverage, life expectancy and other issues and may be greater than the policy's cash surrender value. This means that a shareholder must pay fair market value for the policy or be charged a taxable benefit equal to fair market value.

One planning idea that may overcome some of the disadvantages noted above would be to structure the life insurance ownership through a holding company (multiple if more than one shareholder) that pays the premiums and name the operating company as the recipient of the death benefit. Under such a structure:

- The operating company would not have an adjusted cost basis in the contract and would be able to credit its capital dividend account for the full amount of the life insurance proceeds received.
- By having the life insurance policy owned in the holding company, it is removed from exposure to the creditors of the operating company during the lifetime of the life insured.
- If a shareholder departs or the operating company is sold, the holding company simply makes the death proceeds payable to itself. There is no income tax consequence to this change.

The Canada Revenue Agency has previously indicated that this structure will not be challenged if there is a *bona fide*, non-tax reason for its existence. However, great care should be taken in ensuring that it is properly set up and documented.

The structure of the life insurance policy can either make or break the overall estate plan. It is important to ensure the proper advice at the time the policy is established as well as during periodic reviews of your estate plan. Because of the complexity of these issues, input from your insurance advisor, your accountant and your lawyer may be required.

L/R 5200.01

ACCOUNTING FOR CORPORATE-OWNED LIFE INSURANCE

If, during the life insurance planning process, the decision is made to have the corporation be the owner, premium payer and recipient of the proceeds of a life insurance policy, then the corporate financial statements must reflect that ownership.

In Canada, the Canadian Institute of Chartered Accountants' (CICA's) Handbook does not specifically address accounting for a corporate-owned life insurance policy. It does, however, provide a general framework for accounting for assets, income and expenses.

In the United States, the reporting treatment for corporate-owned life insurance is dealt with in a statement released by the Financial Accounting Standards Board (FASB). It is through these two sources that Canadian business owners determine the appropriate accounting treatment for a corporate-owned life insurance policy.

During the lifetime of the life insured

There are essentially three components to the accounting treatment during the insured's lifetime:

1. The cash surrender value of the life insurance policy is an asset that is recorded on the balance sheet of the company. The amount recorded varies from year to year as the cash surrender value of the policy increases or decreases.
2. The payment of the policy premium will be reflected on the balance sheet of the company as a reduction in cash. However, all other cash transactions that occurred during the year will also be reflected in this account, so the change related to the policy premium will not be separately discernible.
3. The increase in the cash surrender value and the payment of the policy premium are reflected in the company's income statement on a net basis. If the premium paid is greater than the increase in the cash surrender value for the year, the difference between the two is recorded as an insurance expense on the income statement. If the premium paid is less than the increase in the cash surrender value, the difference is recorded as investment income.

It is important to note that the insurance expense does not generally qualify as a deduction in the calculation of the company's taxable income. Conversely, the amount recorded as investment income on the income statement is not included in the calculation of the company's income for tax purposes. Any amounts on the company's financial statements that are not taxable or tax deductible will be adjusted for tax purposes when the corporate income tax return is prepared.

The following numerical examples illustrate this accounting treatment for a corporate-owned life insurance policy:

Example 1

Annual premium	\$1,000
Previous year cash surrender value	500
Current year cash surrender value	750

- The premium paid is greater than the increase in cash surrender value for the year, so the difference between the two is recorded as an insurance expense on the income statement (\$1,000 less \$250).
- The \$250 increase in the cash surrender value (\$750 – \$500) is added to the value recorded on the previous year's balance sheet to reflect the current cash surrender value.
- The payment of the policy premium is reflected indirectly on the balance sheet of the company, since the cash account will have been reduced by that \$1,000 payment.

DR	Life Insurance Expense	750
DR	Investment in Life Insurance	250
CR	Bank	1,000

Example 2

Annual premium	\$1,000
Previous year cash surrender value	3,000
Current year cash surrender value	4,500

- The premium paid is less than the increase in the cash surrender value for the year. In this situation, the difference is not recorded since for accounting purposes assets are recorded at the lower of cost and net realizable value.
- The current cash surrender value of the life insurance policy is an asset that is recorded on the balance sheet of the company but only up to the "cost" of the asset. (In other words, the annual increase in the cash surrender value, to a maximum of the premium paid, is added to the prior year's value. In this case, the \$1,000 premium is added to the previous value of \$3,000 for a new balance of \$4,000.)
- Since the cash surrender value is actually higher than the amount recorded on the balance sheet, the difference, \$500, would be disclosed in the notes to the financial statements.
- The payment of the policy premium will be reflected indirectly on the balance sheet of the company.

DR	Investment in Life Insurance	1,000
CR	Bank	1,000

The cash surrender value of the corporate-owned life insurance policy is recorded at the lower of cost and net realizable value. The actual cash surrender value is \$4,500.

On the death of the life insured

On the death of the life insured, the company receives the proceeds of the life insurance policy. The proceeds received replace the life insurance asset recorded on the balance sheet. The excess proceeds are recorded as income on the income statement. This amount is not included in the calculation of taxable income since insurance proceeds are tax-free.

Example 3

Current year cash surrender value (as recorded on the books of the company)	\$4,000
Life insurance proceeds received	100,000

- The receipt of the life insurance proceeds will create cash in the company equal to the benefit received.
- The cash surrender value of the life insurance policy is no longer an asset, so its balance

must be removed from the balance sheet.

- The entry is balanced by recording a mortality gain on the income statement of the company.

DR	Bank	100,000	
CR	Investment in Life Insurance		4,000
CR	Mortality Gain		96,000

It should be noted that the mortality gain is not a taxable item but rather a method by which the accountant can record the difference between life insurance proceeds received and the asset value recorded on the company's books.

This article has outlined basic accounting for corporate-owned life insurance policies. More complex scenarios may produce more complicated accounting requirements.

I/R 5200.01

INTEREST ON INTEREST

In certain circumstances, a taxpayer may need to borrow funds to pay business or investment expenses. Generally, the resulting interest expense is tax deductible to the extent that the related expenses are tax deductible. However, when a taxpayer borrows funds to pay tax-deductible interest expenses, the above noted rule of thumb may not be entirely accurate.

Interest expense is generally considered to be a non-deductible payment on account of capital. Specific provisions in the Income Tax Act (the "Act"), however, may allow for its deduction as a current expense. This general approach was confirmed by the Supreme Court in the *Gifford* case.

The Act provides that interest expense is generally tax deductible where the loan

was incurred to earn income from business or property. However, money borrowed to pay interest expense does not necessarily meet this test. While the Act does provide for the deductibility of compound interest, it is specific to only the first layer of interest and only if the interest is paid in the year.

The good news is that the Canada Revenue Agency has a long-standing administrative position that allows this type of secondary interest to be deductible where the original loan was incurred to earn income from business or property. The concern, however, is that this is only an administrative position that does not appear to be technically supported by the Act, so it could be subject to future change or challenge.

I/R 7401.00

Subscribe to CLU Comment today at
www.advocis.ca

Contributors to this issue of Comment:

James W. Kraft, CA, MTax, TEP, CFP, CLU, CH.F.C.

Deborah Kraft, MTax, TEP, CFP, CLU, CH.F.C.

Published by:

CLU Institute

350 Bloor Street East, 2nd Floor,

Toronto, Ontario M4W 3W8

T: 416.444.5251 or 1.800.563.5822

F: 416.444.8031

www.cluinstitute.ca • info@cluinstitute.ca

This commentary is published by CLU Institute in consultation with an editorial board comprised of recognized authorities in the fields of law, life insurance, and estate administration.

CLU Institute is the professional organization that administers and promotes the Chartered Life Underwriter of Canada designation.

The articles in CLU Comment are not intended to provide legal, accounting, or other advice in individual circumstances. Seek professional assistance before acting upon information included in this publication.

CLU Comment may not be reproduced or distributed (by reprint, photocopy, electronic copy, or any other means) without the prior written consent of CLU Institute. Any unauthorized use of the foregoing will be prosecuted to the full extent of the law.

Advocis™, CLU™ and APA™ are trademarks of The Financial Advisors Association of Canada.

Publication Agreement # 40069004